

Notes for FOMC Meeting
November 4-5, 1985

Sam Y. Cross

Mr. Chairman, perhaps it would give a clearer perspective if I reviewed developments over the entire six-week period since September 22, when the G-5 made its pronouncements about exchange market intervention, although that goes back a week or so before the last FOMC meeting. As a benchmark, during the week before the G-5 meeting, the dollar was trading around 2.90 DM and 2.42 yen.

You will recall that on the first day after the G-5 communique there was a sharp decline in the dollar, which closed on Monday at 6 to 7 percent below those benchmark levels. The market noted that the U.S. had taken the lead in forging the G-5 agreement, and took seriously the fact that the Administration had shifted its attitude both with respect to intervention and with respect to the implications of a strong dollar. Thereafter the market became impressed by the willingness of the authorities to intervene, in particular, the Japanese authorities, who on their first business day spent \$1.2 billion, accounting for more than 25 percent of the Tokyo market's gross dollar sales, on the day of the market's largest turnover in history. The dollar continued to trend lower through the first week in October. With pressures relatively light, after the Japanese action, U.S. intervention totalled less than \$500 million in the first two weeks after the September 27th announcement.

In the second two weeks, the dollar came under upward pressures, reflecting strong commercial and investor demand. The demand for dollars was spurred by the passing of the IMF meeting without announcement by any of the countries of any new economic policy initiatives to reinforce the intervention. Also, there were statements by foreign officials that were interpreted as expressing satisfaction with the extent of the dollar's decline, and suggesting that it would not fall much farther. In addition, there were expectations developing of stronger U.S. economic growth.

While we felt that some recovery of the dollar was appropriate in the circumstances and should be allowed, we did act to resist sustained upward pressures by selling substantial amounts of dollars, both through agents and directly in our own markets and abroad. As these upward pressures intensified around mid-October, we sold dollars openly and aggressively against both the mark and the yen. On October 16, as the dollar reached its highs for the period, we sold almost \$900 million, and on the next day we openly sold an additional \$170 million as the dollar was easing back from its highs after a disappointing GNP figure. Others cooperated in resisting the strong upward pressure on the dollar, and we were in frequent, sometimes around-the-clock contact with our colleagues at the Bank of Japan, the Bundesbank, and elsewhere to coordinate intervention operations. During that second two weeks of the six-week period, the U.S. sold more than \$2 billion (\$2.167 billion) and the other G-5 countries sold almost another \$2 billion (\$1.898 billion).

Over the last two weeks of the six-week period, in response both to the intervention operations and the less optimistic outlook for U.S. economic activity, much of the upward pressure on the dollar relative to the European currencies abated, although the market continued to sense a strong potential demand for dollars by Japanese investors. Consequently, our dollar sales were much more modest and generally concentrated against yen. For the most part, these operations were designed to defuse pressures before they could build, on occasion nudging the exchange rate when a good opportunity presented itself. Toward the end of the period, the Bank of Japan, responding to the continuing underlying investment demand for dollars, acted conspicuously to guide Japanese market rates significantly higher. Many market participants viewed this action as the first of a series of steps to be taken by the G-5 countries to lower interest rate differentials favorable to the dollar. The Bundesbank, when it offset a seasonal overabundance of liquidity from its markets, was viewed as also changing its policy toward the same objective. Although the idea of a G-5 interest rate agreement has been denied by many sources, the dollar has declined further in this environment and now stands at just below 2.66 DM and 2.08 yen.

The dollar is now 10-1/2 percent below the pre-September 22 benchmark figure for the DM I mentioned earlier, and 14 percent below the figure for the yen. Dollar sales by the United States in the six-week period amounted to \$3.2 billion. Dollar sales by other members of the G-5 totalled \$4.9 billion during the six-week period. Of the \$3.2 billion in U.S. sales, a total of \$2.8 billion took place since the last FOMC meeting--\$1.65 billion against DM and \$1.14 billion against yen. All of these sales of dollars by the U.S. were divided equally between the Federal Reserve and Treasury.

These increases in Treasury and System holdings of foreign currency have been invested using existing facilities, as always aiming to obtain market related rates of return along with the required high degree of liquidity and safety. In the case of our yen acquisitions, all have been invested through the Bank of Japan in

For the German marks we have acquired, the Bundesbank requested that

all of the increase has gone into mark deposits held with the BIS. The Bundesbank's request to us is similar to those we understand it has made of other central banks buying large amounts of marks in the last year or so, and stems from

As you know, the level of our intervention activity resulted in our approaching our limit on the maximum change in the Federal Reserve's foreign currency balances between FOMC meetings, and the Committee approved a \$500 million increase in this limit to \$2 billion. As it developed, we did not have to use this additional leeway, and the limit automatically reverts to \$1.5 billion.

Mr. Chairman, at the last meeting, the Committee approved a maximum overall position limit of \$10 billion. Within that \$10 billion overall limit, there are informal limits on individual currency holdings--at the level of \$6 billion equivalent in DM, \$3 billion in yen, and \$1 billion in other currencies. At present, we have ample room under the overall formal limit of \$10 billion--we are about \$3 billion below that limit. But we may need to change some of the informal limits, depending on developments in the weeks ahead.

Mr. Chairman, I recommend that the Committee ratify the transactions since the October meeting that I have described. My only other recommendation is that the Committee approve renewal of the System's reciprocal foreign currency arrangements with foreign central banks and the BIS, as these come up for renewal in December. We are suggesting no change in any of the agreements.

NOTES FOR FOMC MEETING
November 5, 1985
Peter D. Sternlight

Domestic Desk operations since the October 1 meeting sought to maintain the same degree of reserve pressure intended at the time of that meeting. Narrow money growth halted in October, on average a sharper slowdown than had been anticipated a month ago, but this still left the M1 measure far above the Committee's intended range from the second to fourth quarter. The broader aggregates also slowed in October, reflecting both the stall-out in M1 and some slowing in time deposit components. This brought M2 just back within its annual growth cone in October, after having been above its range in September, while M3 remained near the middle of its annual range. Against this background, the slowdown in October growth was not seen as calling for a change in planned reserve pressures, particularly against the background of continued moderate growth in the economy and for the most part a weakening in the dollar internationally.

Accordingly, reserve paths continued essentially to incorporate a \$500 million allowance for seasonal and adjustment borrowing, although in the early part of the interval as we proceeded through the maintenance period ending October 9, an allowance was made for relatively high borrowing in the early part of that period traceable to hurricane disruptions and statement date pressures at the end of September. There were also unusual pressures on October 9 itself, when the Treasury, steering its tortuous way between the Scylla of debt limit and Charybdis of zero cash balances, scheduled a cash management bill for auction and payment that same day. Together, those factors boosted borrowing in the October 9 period to about \$770 million. In the next full period, borrowing averaged a close-to-path \$470 million while so

far in the current period it has averaged a below path \$385 million (through last weekend).

Fed funds have averaged close to the expected eight percent area, looking at full weeks or reserve periods, but there were some significant departures on particular days. Most notable, on October 9, when the Treasury sold its same day cash management bill, there was small-scale late trading at rates of 10 to 40 percent. On the other hand, early in the current reserve period, there was substantial trading in the 7 1/2 to 7 3/4 percent range as excess reserves were temporarily over-abundant. So far in the current reserve period, funds have averaged 8.02 percent.

Outright operations were relatively light for the Domestic Desk, including the sale of \$265 million of Treasury bills to foreign accounts and purchases of about an equal amount of bills from those accounts late in the period. This would ordinarily be a period of moderate reserve provision, but that was being accomplished through Foreign Desk currency purchases and somewhat lower than normal Treasury balances as the debt limit problem dragged on. We did have a number of occasions to inject reserves temporarily by passing through customer repurchase agreements--eight times--and five occasions when we withdrew reserves for short periods through matched sale purchase transactions.

The uncertain timing of action on the debt ceiling remains a complication for reserve management--as well as in other respects--for the period ahead. As you know, there was one day last month, October 8, when the Treasury ran a small inadvertent overdraft which was plugged to zero the next morning through an accounting adjustment. After some unusual use of the Federal Financing Bank and certain trust funds, their balance is probably okay

for about the next 10 days, though perhaps with some close calls and occasionally lower than normal balances. The so-called "drop-dead" date now is November 15 when massive new cash is needed for interest payments. Without uncorking still new gimmicks, which the Administration has professed an unwillingness to use, we don't think they can get past November 15 and would have to default at that time unless the Congress has acted.

Financial markets responded to diverse and often confusing signals over the period, with uncertainty about the Treasury's financing plans a continuous background factor. For intermediate and longer-term Treasury issues there was a net yield decline of about 20 to 35 basis points. It stemmed essentially from a prevalent view that the economy was expanding only modestly, with inflation in a state of remission, and a fair likelihood that monetary policy could turn more accommodative in coming months--partly in furtherance of the G-5 efforts to strengthen the major nondollar currencies. This view prevailed even though at times there was also a sense that the System was aiming, short-run, for slightly more cautious conditions of reserve availability. With pent-up appetite for long-delayed coupon issues, the market bid vigorously last week for four- and seven-year notes, and pretty well also for twenty-year bonds. The Treasury raised nearly \$18 billion through these issues, the bulk of the \$19 billion raised through coupon issues during the period. It remains to be seen whether the market appetite will also be good for the three-, ten-, and thirty-year issues that normally make up the Treasury's mid-quarter financing and would be up for auction this week but for the debt limit hang-up. Last week's auctions have filled in a lot of short positions, and fresh demand may depend on the market's finding further cause for optimism that rates will decline in coming months.

The bill market turned in a more staid performance over the period, with some short maturities rising in rate and longer ones edging off only slightly. The bill market seemed to be responding more than coupons to the perception that Fed funds would likely vary around 8 percent--perhaps in a "broad" range of 7 3/4 to 8 1/8 percent. Three- and six-month bills were auctioned today at about 7.22 and 7.30 percent compared with 7.07 and 7.24 percent just before the last meeting. The Treasury will have raised \$8 billion in the bill market over the period in the form of short-term cash management bills including \$5 billion on October 9 and another \$3 billion just announced today for auction and payment tomorrow.

The Federal agency market attention continued to focus on the beleaguered Farm Credit System. Through most of the period, spreads of Farm Credit paper over Treasuries tended to widen in response to, or anticipation of, adverse news reports, including a GAO report projecting multi-billion dollar losses for the year ending next June, and FCA's own report of a half-billion loss in the latest quarter. By late October, the spreads were largely around 100 basis points or somewhat more. The spreads narrowed temporarily by about 20 basis points last week following press reports that the Administration was leaning toward some sort of back-up plan, and FCA got the benefit of that temporary narrowing in pricing a six-month issue about 85 basis points over Treasuries. The next day, Administration testimony seemed to shy away from any near-term aid plan and also forecast a heavy fourth-quarter loss for the System that sent spreads back to the 100 basis point area. Market participants did not seem excessively disturbed by these events, though, essentially, I think, because there is a persistent underlying belief that the Farm Credit System won't be allowed to fail.

Elsewhere, I should just mention the tax-exempt market where rates declined considerably more than for Treasury issues. One broad index fell about 60 basis points. A few months ago, exceptionally heavy issuance in this market caused rates to back up compared with Treasury issues. Much of the heavy issuance was undertaken to get ahead of possible Congressional restrictions on certain types of tax-exempt financing starting next year. More recently, given the development of unusually attractive rates compared with taxable bonds, demand picked up substantially. Some of it has come, reportedly, from investors that don't normally seek tax-exempt income but are attracted to the current spreads as a short-term holding. Also, we hear of some bank buying on the basis that subsequent legal changes may make it more costly on an after tax basis for them to carry tax-exempt investments purchased after year-end.

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FOMC Briefing

The staff's forecast of the economy prepared for this meeting of the Committee is little changed, although we have shaded a few tenths off projected growth of real GNP for this quarter and next year. Economic activity is expected to advance at a 2-1/2 percent annual rate over the forecast period, which is thought to be consistent with an unemployment rate that is stuck at a bit over 7 percent.

Information on developments in the current quarter is quite limited; essentially all we have in hand is the October labor market reports, a tentative reading on industrial production, and partial data on October auto sales. The labor market surveys were upbeat in October as payroll employment rose more than 400,000. Employment gains were widespread among sectors, including growth in manufacturing and construction as well as trade and services. Owing to seasonal adjustment problems, it would seem better to average October with the weaker September report and doing that still provides growth of employment somewhat above the experience earlier in the year. Given the labor market information and some physical product data, it appears that industrial production was about unchanged in October, held down in part by the Chrysler strike which came after the employment surveys. Domestic auto sales in the first

20 days of October plunged as expected following the end of most cut-rate financing incentives, and auto inventories are now in the process of being rebuilt.

On the whole it seems that moderate growth this quarter is a good bet, but in our thinking some additional caution flags have been raised as we focused on the forecast through next year. In the consumer sector, spending attitudes are reportedly good and outside the auto sector we have been seeing moderate gains in spending in recent months. However, future gains in spending would seem to be constrained by the prospect of limited expansion in real disposable income--a bit over 2 percent in the forecast--high debt burdens and a very low saving rate. I might note that the 4 percent saving rate in the forecast takes off from currently published data, and it appears likely there will be a sizable upward revision to the data but that will still leave us significantly below historical norms.

Developments in the investment sectors in the forecast contribute to holding down prospective gains in income. Housing, frankly, has been a puzzle for some time, but clearly housing starts have yet to show a response to the earlier decline in mortgage interest rates; starts edged lower in the spring and declined on average for the third quarter. We have reduced our expectations for this sector a little but continue to forecast some pickup in starts over the course of the

forecast, partly in response to some further drifting down of mortgage interest rates.

We have also lowered our expectations somewhat for business fixed investment spending. New orders for nondefense capital equipment rose 5 percent last quarter, but the bulk of the increase was for aircraft and parts which have long lead times; excluding aircraft, nondefense capital goods orders have been about flat this year. Survey evidence on 1986 capital spending plans has become available to us on a confidential basis since the last Committee meeting and both the McGraw Hill survey (down 1 percent in nominal terms) and the Merrill Lynch survey (up 3 percent) are weak. Even after allowing for their tendency to underpredict, the surveys suggest cautious business planning for next year. Our forecast is somewhat above these surveys, but with ample capacity, moderate growth of final sales, and uncertainty over tax reform, there do not seem to be any particular sources of strength available.

On a more positive note, the decline in the foreign exchange value of the dollar that has occurred and assumed to continue at a more moderate rate should produce an improvement in net exports. For 1986, net exports are projected to contribute to growth of real GNP for the first time since 1980. Also positive has been the continuing generally good performance of wages and prices. Although some transitory factors--the ending of cut-rate auto financing and higher meat

prices, for example--could boost near-term monthly price indicators, inflation this year is expected to be around 3-1/2 percent, the same or better than last year depending on the measure used. Only a small acceleration is expected next year, in response to a weaker dollar.